OLL 84-1551
17 April 1984

MEMORANDUM FOR: [redacted]
Legal Advisor
Voluntary Investment Plan

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FROM: [redacted]
Chief, Legislation Division
Office of Legislative Liaison

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SUBJECT: H.R. 4170, the Tax Reform Act of 1984

1. Section 119 of H.R. 4170, the Tax Reform Act of 1984, provides that pension plans will no longer be considered "qualified" if substantially all of the accrued benefits under the plan are derived from employee contributions. A copy of this provision, as well as the relevant portions of the Supplemental Report of the House Ways and Means Committee on this provision, are attached at Tabs A and B. As you can see from the attached report, certain abuses resulting from financial institutions promoting qualified pension plans that provide for no employer contributions led the Committee to conclude that plans used in this manner are not bona fide retirement plans and should not qualify for favorable tax treatment under the Code.

2. The potential adverse consequences that this provision could have on plans such as the Voluntary Investment Plan (VIP), which are funded exclusively by employee contributions, have been mitigated by certain comments (attached at Tab C) made on the House floor by the bill's sponsor, Chairman Rostenkowski. Mr. Rostenkowski notes that the general rule in determining the extent to which accrued benefits are derived from employee contributions is that each plan of the employer is to be tested separately. In the case of certain plans maintained by the Federal Government, however, this determination is to be made by aggregating all plans of the employer that constitute a single interrelated program of benefits. Thus, in the case of VIP, the Civil Service and CIARDS retirement programs maintained by the Agency could be aggregated and would thus preclude VIP from being characterized as a plan the benefits of which are substantially derived from employee contributions under this definition.

3. The Senate earlier passed its version of this bill, entitled "The Deficit Reduction Act of 1984," on 5 April and it also included a provision addressing qualified plans in which the accrued benefits were derived substantially from employee

contributions. Unlike the House provision, the Senate provision (attached at Tab D) does not disqualify or otherwise adversely affect the plan itself, but simply removes the favorable tax treatment that is provided to distributions from qualified plans if the distribution is made from a plan where substantially all contributions are employer contributions.

4. While it would appear that VIP is not adversely affected by either version of the bill, if the House version is adopted by the Conference Committee, we must be sure that Mr. Rostenkowski's qualification of the aggregation rules provided during the House floor consideration are factored into the IRS regulations which implement this provision. I would appreciate any comments you may have on the attached materials, and your suggestions as to what, if any, action might be required at this time.

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Attachments

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TAB A

SEC. 119. DISQUALIFICATION OF PLAN WHERE SUBSTANTIALLY ALL CONTRIBUTIONS ARE EMPLOYEE CONTRIBUTIONS.

(a) GENERAL RULE.—Subsection (a) of section 401 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by inserting after paragraph (24) the following new paragraph:

"(25) A trust shall not constitute a qualified trust under this section if substantially all of the accrued benefits under the plan of which such trust is a part are derived from employee contributions."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (2) of section 402(a) (relating to certain employees' annuities) is amended by striking out "and (22)" and inserting in lieu thereof "(22), and (25)".

(2) Paragraph (3) of section 818(a) (defining pension plan contracts), as amended by title II of this Act, is amended by striking out "and (22)" and inserting "(22), and (25)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after March 31, 1984.

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TAB B

9. Disqualification of Plan Where Substantially All Contributions are Employee Contributions (sec. 119 of the bill and sec. 401 of the Code)

Present Law

Under a tax-qualified pension, profit-sharing, or stock bonus plan ("qualified pension plan"), qualified annuity plan, a tax-sheltered annuity, or a government plan, contributions may be made by (1) the employer, (2) the employees, or (3) both. Thus, present law permits a qualified pension plan to be funded solely by employee contributions.

Employee contributions to a qualified pension plan generally are not deductible by the employee. Contributions by an employee that meet certain requirements, which are similar to the rules relating to IRAs, may be deductible from gross income. Employee contributions to a qualified plan (whether or not deductible) may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, employee contributions are presumed to be nondiscriminatory if (1) the amount contributed does not exceed certain limits expressed as a percentage of pay and (2) the opportunity to make the contributions is reasonably available to a nondiscriminatory group of employees.

Nondeductible employee contributions may be withdrawn from a qualified pension plan at any time without a tax penalty. In addition, the first withdrawals of nondeductible contributions are treated as a return of the nondeductible contributions, which are not includible in gross income. After the balance of the nondeductible contributions has been exhausted, other withdrawals are considered to be income.

Reasons for Change

The committee understands that some financial institutions are promoting master and prototype qualified pension plans that provide for no employer contributions, but instead permit only nondeductible employee contributions. The favorable tax treatment of amounts under qualified plans and the ready availability of amounts attributable to employee contributions enable these plans to be used as tax-favored savings and brokerage accounts that offer employees the opportunity to withdraw funds using credit cards or checks without any amount being included in the employee's income. Clearly plans used in such a manner are not bona fide retirement plans. The committee believes that a plan should not be treated as a qualified plan if substantially all of the benefits under the plan are attributable to employee contributions.

Explanation of Provision

The bill provides that a plan is not a qualified plan (and a trust under the plan is not a qualified trust) if substantially all of the accrued benefits under the plan are derived from employee contributions. The provision applies without regard to whether the employee contributions are deductible. In determining whether a plan meets the requirements of the bill, the committee intends that each plan be tested separately. Accordingly, a plan would not be treated as meeting the requirements of the bill merely because accrued benefits derived from employer contributions are provided under another plan of the employer.

The committee does not intend that a plan should lose its qualification merely because substantially all benefits attributable to employer contributions have been distributed under the plan, so long as the plan continues to provide for the accrual of employer-provided benefits that will, when accrued, be substantial in relation to benefits derived from employee contributions, and it is reasonable to expect that the future accruals will occur.

Of course, the bill does not affect the status of an organization that is exempt from tax under other provisions of the Code. In particular, the exempt status of an organization that is exempt under section 501(c)(5) would not be affected.

Under the bill, a profit-sharing plan is not to be disqualified merely because employer contributions have not been made due to the employer's lack of profits.

Effective Date

The provision applies to plan years beginning after March 31, 1984.

10. Discrimination Standards A
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Prese

Under present law, if a tax
bonus plan meets certain requ
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in income any employer contrib
the employee could have elected
in cash.

Present law provides that the
can elect to defer, tax-free, und
rangement depends (in part) on
other highly paid employees bec
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highly paid, for this purpose, if
the employees.

The special tests applicable to
not permit employer-provided s
into account in determining wh
ment is discriminatory. Howev
permit a cash-or-deferred arran
discrimination standards appli
permit social security to be tak
crimination.

Reasons

The committee is concerned
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ferred as employer contributio
ments even though the employe
ments satisfy only the general
to qualified plans rather than
contained in section 401(k). Bec
discrimination rules allow em
counted as employer contribut
permit too high a difference bet
paid and other employees. Th
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fies the special nondiscriminatio

Explanatio

Under the provision, a cash-
fied cash-or-deferred arrangeme
provided by the Code relating t

nterest on certain very large
ler loans.

TAX-EXEMPT BONDS

housing costs and high in-
es continue to present a for-
barrier to low- and middle-
ersons trying to buy their
e, the bill extends the tax ex-
for qualified mortgage bonds
issued prior to January 1,
bill provides that veterans
bonds will generally count
tate mortgage bond volume
are subject to the 1989 sunset
an alternative to mortgage
igned to target a greater por-
e benefit of tax exemption to
yers, State and local govern-
n trade in their mortgage
hority for the right to issue
s to qualified home buyers.
note greater selectivity in the
ax-exempt bonds for private
and to control the Federal
impact, the bill subjects pri-
ivity tax-exempt bonds to
volume caps. Private activity
clude most industrial develop-
nds (IDB's) and student loan
onds used to finance projects
ltifamily residential rental
are exempted from the caps.
ally, IDB's used to finance
on or trade show facilities, air-
cks, wharves and certain mass
ng facilities are exempted
caps where the facilities are
or tax purposes by a State or
vernment. The volume caps
set at $150 for each resident
State, reduced to $100 per
ter 1986 to reflect the sunset
resent law for small issue

ill contains additional meas-
assure the appropriate use of
npt bonds and to protect
the double benefit of tax-
bond financing and acceler-
t recovery.

PRIVATE FOUNDATIONS

ll refines current tax laws reg-
private foundations to better
ge and enhance their charita-
ities, while retaining the basic
ons against abuse. The bill
: incentives for additional
le giving to foundations and
certain unnecessary or
burdensome restrictions that
pede charitable activities.

HIGHWAY EXCISE TAXES

nt law imposes an annual use
heavy highway vehicles and a
per-gallon tax on highway
uel. The use tax, which gener-
pends on weight but not on
, is scheduled to increase sig-
ly on July 1, rising from $240
0 on the heaviest trucks.
at the highway excise tax
will correlate more closely
les of actual use, the bill re-
he heavy vehicle use tax from
es levels and increases the
uel tax. This is done without
lly affecting the total amount of excise taxes collected or the distribution of those taxes among users of different types of vehicles. Beginning in July, 1984, the maximum use tax is lowered to $500 on vehicles over 72,000 pounds and the diesel fuel tax is raised to 14⅛ cents per gallon. Vehicles weighing less than 55,000 pounds will pay no heavy vehicle use tax. To shield owners of light vehicles from these changes, the bill provides a one-time advance repayment of the extra fuel taxes expected to be paid over the normal useful life of diesel cars, pickup trucks and other light vehicles.

SIMPLIFICATION AND TECHNICAL CORRECTIONS

The bill simplifies the tax law in many areas, including the computation of income tax credits, determination of an individual's liability for making estimated income tax payments, the treatment of transfers of property between spouses, and other matters.

In general, the bill groups existing income tax credits into logical categories and provides uniform tax liability limitations and carryover rules. The business credits will be combined into one credit and a 3-year carryback and 15-year carryforward period will be allowed on a first-in-first-out basis.

The individual estimated income tax rules of present law are simplified and clarified by the bill. Generally, an individual will be required to make estimated tax payments (including withholding payments) equal to the lesser of 80 percent of the current year's tax or 100 percent of the prior year's tax.

Under present law, gain is recognized on certain transfers of property in exchange for marital rights of a spouse or former spouse. The bill provides that property transfers between spouses or, if incident to divorce, between former spouses, will not result in the recognition of gain or loss.

Finally, the bill contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983 and other recently enacted tax legislation.

CLARIFYING REMARKS

Several questions on the proper interpretation of the committee bill have arisen since the committee report was filed. As manager of the bill, I would like to offer clarification of these points.

Under section 112 of the committee bill, the time at which employers are entitled to deduct contributions made under an arrangement to defer compensation is the time at which the payments are made to the employees or independent contractors. The committee report clarifies that this special deduction timing rule will not apply to accrued compensation paid within a brief time after the close of the taxable year, consistent with typical payroll practices. It has come to our attention that, in some cases, employers presently are accruing year-end bonuses which are not able to be paid until the following year because of mechanical difficulties in computing the bonus amount, which may be based, for example, on total compensation or some other figure which cannot be determined precisely until shortly after the end of the year. The committee intends that, in such a case, payments within 2½ months after the close of the taxable year will be considered to be payments made within a brief time after the close of that year. Thus, if this requirement is met under such an arrangement, employers could continue to deduct the amount in the year before it is actually paid.

Under section 119 of the bill, a plan substantially all of the accrued benefits of which are derived from employee contributions is not a qualified pension plan. The committee report clarifies that, for purposes of determining the extent to which accrued benefits are derived from employee contributions, each plan of the employer is tested separately. The committee intends that this determination shall be made, in the case of certain plans maintained by the Federal Government or an instrumentality of the Federal Government, by aggregating all plans of the employer that constitute a single, interrelated program of benefits. Plans maintained by an employer are aggregated for this purpose only if, first, the plan is not maintained as part of a master or prototype plan designed and administered by an unrelated person and in the management of which the employer does not actively participate, and second, the employer maintains a defined benefit plan that is the primary plan for most retirement benefits and a voluntary savings program to which employees may contribute as a supplement to the primary plan.

Section 161 of the bill provides that the recovery of amounts for which a credit was allowed will result in an increase in tax. I wish to clarify that this provision will not apply where, for example, the research credit is allowed and the results of the research are later licensed and sold.

Under section 211 of the bill, there is proposed a new code section 816 which defines a life insurance company for Federal tax purposes. By way of amplification of the committee report, I would like the record to reflect our understanding that a life company that otherwise qualifies under this test would not otherwise fail qualification by reason of its stock ownership of life insurance company subsidiaries and receipt of dividends from such life subsidiaries, even if those life subsidiaries were larger than the parent. Of course, this determination should be made looking at all the facts and circumstances (without regard to the receipt of dividends from life subsidiaries), so as to prevent an abuse of the

SEC. 89. TREATMENT OF DISTRIBUTIONS OF BENEFITS SUBSTANTIALLY ALL OF WHICH ARE DERIVED FROM EMPLOYEE CONTRIBUTIONS.

(a) IN GENERAL.—Subsection (e) of section 72 (relating to amounts not received as annuities) is amended by adding at the end thereof the following new paragraph:

"(7) SPECIAL RULES FOR PLANS WHERE SUBSTANTIALLY ALL CONTRIBUTIONS ARE EMPLOYEE CONTRIBUTIONS.—

"(A) IN GENERAL.—In the case of any plan or contract to which this paragraph applies, subparagraph (D) of paragraph (5) shall not apply to any amount received from such plan or contract.

"(B) PLANS OR CONTRACTS TO WHICH THIS PARAGRAPH APPLIES.—This paragraph shall apply to—

"(i) any trust or contract described in clause (i) or subclause (I) or (II) of clause (ii) of paragraph (5)(D) if substantially all of the accrued benefits under the plan of which such trust is a part (or which purchases such contract) are derived from employee contributions, and

"(ii) any contract described in subclause (III) of clause (ii) of paragraph (5)(D) if substantially all of the benefits are derived from amounts which are not excluded from gross income under section 403(b)(1).".

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (D) of section 72(e)(5) (relating to contracts under qualified plans) is amended by striking out "This" and inserting in lieu thereof "Except as provided in paragraph (7), this".

(2) Paragraph (3) of section 72(p) (defining qualified employer plan) is amended by inserting "other than a plan described in subsection (e)(7)" after "section 219(e)(3)".

(c) EFFECTIVE DATES.—The amendments made by this section shall apply to any amount received or loan made after the 90th day after the date of the enactment of this Act.

SEC. 90. REPEAL OF ESTATE TAX EXCLUSION FOR QUALIFIED PENSION PLAN BENEFITS.

(a) IN GENERAL.—Section 2039 (relating to inclusion in the gross estate of annuities) is amended by striking out subsections (c), (d), (e), (f), and (g).

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to the estates of decedents dying after December 31, 1984.

(2) EXCEPTION FOR PARTICIPANTS IN PAY STATUS.—The amendments made by this section shall not apply to the estate of any decedent who—

(A) was a participant in any plan who was in pay status on December 31, 1984, and

(B) irrevocably elected before the date of the enactment of this Act, the beneficiary and form of benefit.

(3) PAY STATUS RULE EXTENDED TO $100,000 LIMITATION.—Subsection (c) of section 245 of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by inserting ", except that such amendments shall not apply to the estate of any decedent who was a participant in any plan who was in pay status on December 31, 1982, and irrevocably elected before January 1, 1983, the beneficiary and form of benefit".

SEC. 91. AFFILIATED SERVICE GROUPS, EMPLOYEE LEASING ARRANGEMENTS, AND COLLECTIVE BARGAINING AGREEMENTS.

(a) ATTRIBUTION RULES FOR AFFILIATED SERVICE GROUPS.—

(1) IN GENERAL.—Subparagraph (B) of section 414(m)(6), as in effect for taxable years beginning after December 31, 1983, is amended by striking out "section 267(c)" and inserting in lieu thereof "section 318(a)".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to taxable years beginning after December 31, 1984.

(b) EMPLOYEE LEASING EXCEPTION ONLY APPLIES TO NON-EMPLOYEES.—

(1) IN GENERAL.—Paragraph (2) of section 414(n) (defining leased employee) is amended by striking out "any person" in the material preceding subparagraph (A) and inserting in lieu thereof "any person who is not an employee of the recipient and".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to taxable years beginning after December 31, 1983.

(c) DETERMINATION OF WHETHER THERE IS A COLLECTIVE BARGAINING AGREEMENT.—

(1) IN GENERAL.—Subsection (a) of section 7701 (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(46) DETERMINATION OF WHETHER THERE IS A COLLECTIVE BARGAINING AGREEMENT.—In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term 'employee representatives' shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer.".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall take effect on April 1, 1984.

PART II—WELFARE BENEFIT PLANS

SEC. 95. ADDITIONAL REQUIREMENTS FOR TAX-EXEMPT STATUS OF CERTAIN ORGANIZATIONS.

(a) GENERAL RULE.—Part I of subchapter F of chapter 1 (relating to exempt organizations) is amended by adding at the end thereof the following new section:

"SEC. 505. ADDITIONAL REQUIREMENTS FOR ORGANIZATIONS DESCRIBED IN PARAGRAPH (9), (17), OR (20) OF SECTION 501(c).

"(a) CERTAIN REQUIREMENTS MUST BE MET IN THE CASE OF ORGANIZATIONS DESCRIBED IN PARAGRAPH (9), (17), OR (20) OF SECTION 501(c).—

"(1) VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS, ETC.—An organization described in paragraph (9) or (20) of subsection (c) of section 501 which is part of a plan of an employer shall not be exempt from tax under section 501(a) unless such plan meets the requirements of paragraphs (1), (2), and (3) of subsection (b).

"(2) SUPPLEMENTAL UNEMPLOYMENT COMPENSATION BENEFIT TRUSTS.—A trust described in paragraph (17) of subsection (c) of section 501 shall not be exempt from tax under section 501(a) unless the plan of which such trust is a part meets the requirements of paragraphs (1) and (3) of subsection (b).

"(3) EXCEPTION FOR MULTIEMPLOYER PLANS.—Paragraphs (1) and (2) shall not apply to any organization which is part of a multiemployer plan (within the meaning of section 414(f)) maintained pursuant to 1 or more collective bargaining agreements between 1 or more employee organizations and 1 or more employers.

"(b) REQUIREMENTS.—

"(1) LIMITATION ON BENEFITS PROVIDED TO KEY EMPLOYEES.—A plan meets the requirements of this paragraph for a year only if, with respect to each class of benefits, the benefits of such class provided under the plan (determined without regard to actual benefit payments) during such year to key employees do not exceed 25 percent of the benefits of such class provided under such plan (as so determined) during such year.

"(2) NONDISCRIMINATION REQUIREMENTS.—

"(A) IN GENERAL.—A plan meets the requirements of this paragraph only if—

"(i) each class of benefits available under the plan benefits a classification of employees which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated individuals, and

"(ii) in the case of each class of benefits, such benefits do not discriminate in favor of employees who are highly compensated employees.

A life insurance, disability, severance pay, or supplemental unemployment benefit shall not be considered to fail to meet the requirements of clause (ii) merely because the class of benefits bears a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of employees covered by the plan.

"(B) AGGREGATION RULES.—Rules similar to the rules of section 4976(g)(4) shall apply for purposes of this subsection.

"(3) PLAN MUST MEET OTHER REQUIREMENTS FOR EXCLUSION.—A plan meets the requirements of this paragraph for any taxable year only if with respect to each class of benefits—

"(A) which is excludible from gross income under this title, and

"(B) with respect to which the plan must meet any requirements of this title before such benefits are so excludible,

the plan meets such requirements.

"(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) KEY EMPLOYEE.—

"(A) IN GENERAL.—The term 'key employee' has the meaning given such term by section 416(i)(1) (determined without regard to clause (ii) or (iv) of subparagraph (A) thereof).

"(B) MEMBERS OF FAMILY OF KEY EMPLOYEE.—Any member of the family (within the meaning of section 318(a)(1)) of a key employee shall be treated as a key employee.

"(C) INDIVIDUAL CONTINUES TO BE KEY EMPLOYEE.—Any individual who becomes a key employee with respect to any plan shall continue to be treated as a key employee with respect to such plan whether or not the key employee continues to be described in section 416(i)(1) (as modified by this paragraph).

"(2) HIGHLY COMPENSATED INDIVIDUAL.—For purposes of this subsection, the term 'highly compensated individual' has the meaning given such term by section 105(h)(5). For purposes of the preceding sentence, section 105(h)(5) shall be applied by substituting '10 percent' for '25 percent'.

"(3) APPLICATION WITH SECTIONS 127 AND 129.—If section 127 (relating to educational assistance) or section 129 (relating to dependent care assistance) apply to 1 or more classes of benefits under a plan to which this section applies, paragraphs (1) and (2) of subsection (b) shall not apply to such classes of benefits.

"(4) FAILURE WITH RESPECT TO FACILITIES.—An organization to which this section applies shall not fail to be exempt from tax under section 501(a) merely because the plan fails to meet the requirements of paragraph (1) of subsection (b) with respect to a class of benefits which consists of the use of a facility.

"(5) PLANS DEFINED; INDEPENDENT CONTRACTORS.—Rules similar to the rules of paragraphs (2) and (3) of section 4976(h) in application of this section.

"(6) REGULATIONS RELATING TO CLASSES OF BENEFITS.—The Secretary may prescribe regulations for determining—

"(A) the method by which benefits may be assigned to a class for purposes of subsection (b), and

"(B) the amount of benefits allocated to an employee under subsection (b)(1).